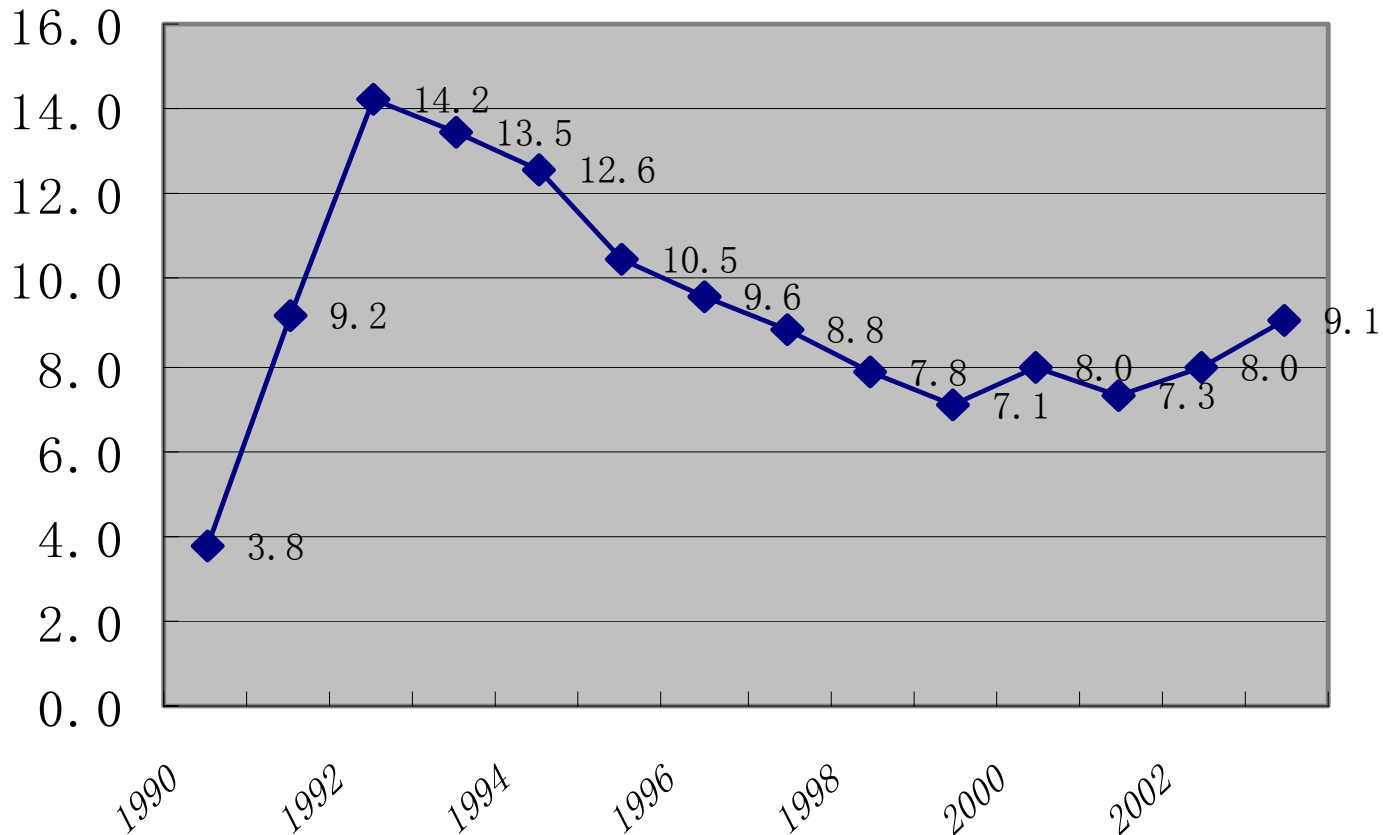


# I China's Growth Potential

Like any market economy, the Chinese economy has been moving cyclically with a strong growth trend. It has bottomed out from the last cycle and entered a new cycle of expansion since the second half of 2002.

## Growth Rate of GDP



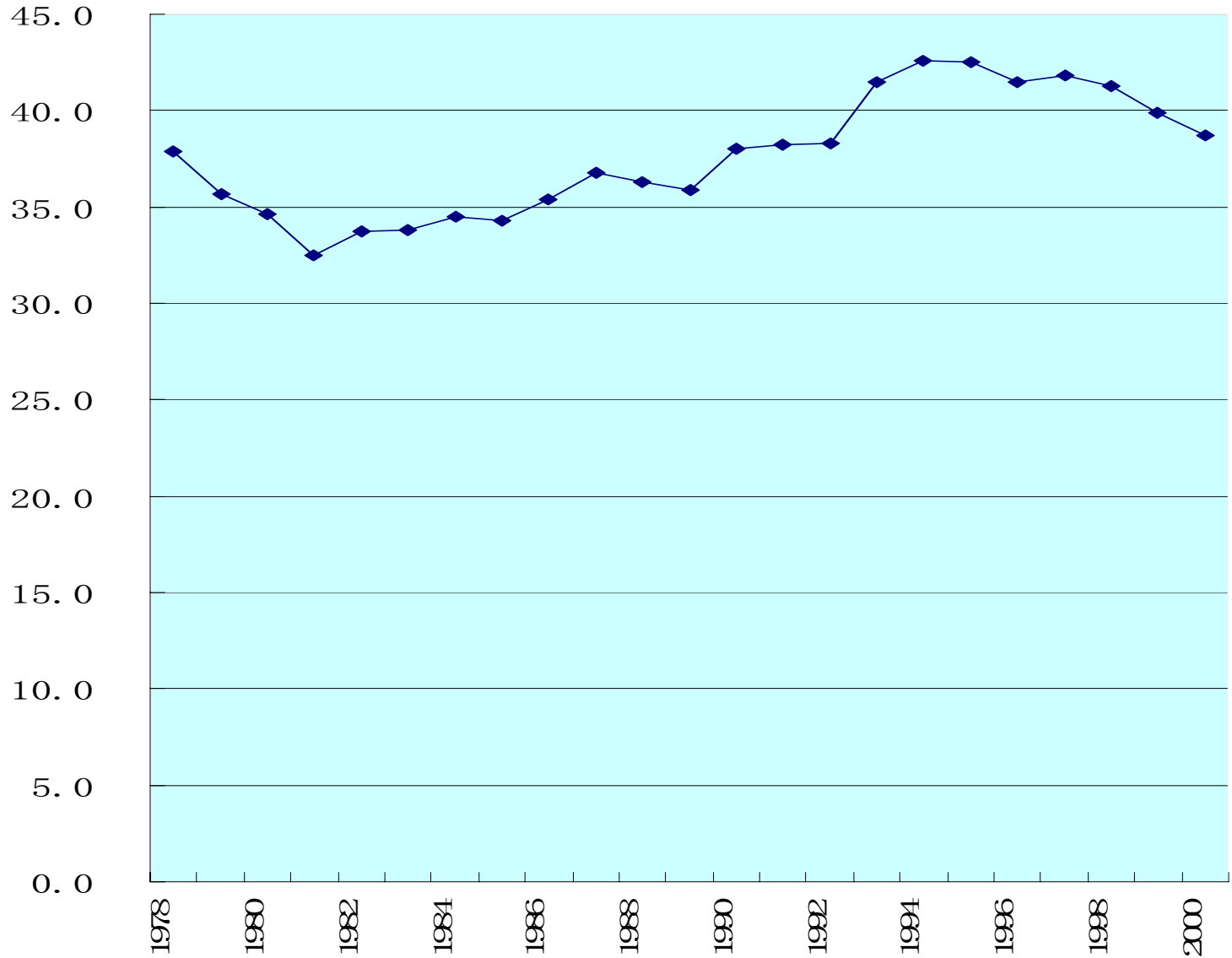
# China's growth potential: the supply side of the economy

the high savings rate offsets the low capital output ratio. Infinite labor supply offsets the low labor productivity. Unless the savings rate and demographic trend have changed significantly downward or the productivity has dropped dramatically, China should be able to maintain a relatively high growth rate. In fact, China's savings rate is very high, and is unlikely to fall in the near future. China's productivity has been rising slowly, and let alone the existence of the abundant supply of labor. Therefore it is obvious that at least in the short-run, China's potential growth rate should not change significantly.

$$n = \frac{\dot{i}}{v} = \frac{as}{v}$$

$$n = p + \lambda$$

中国的储蓄率 (%)

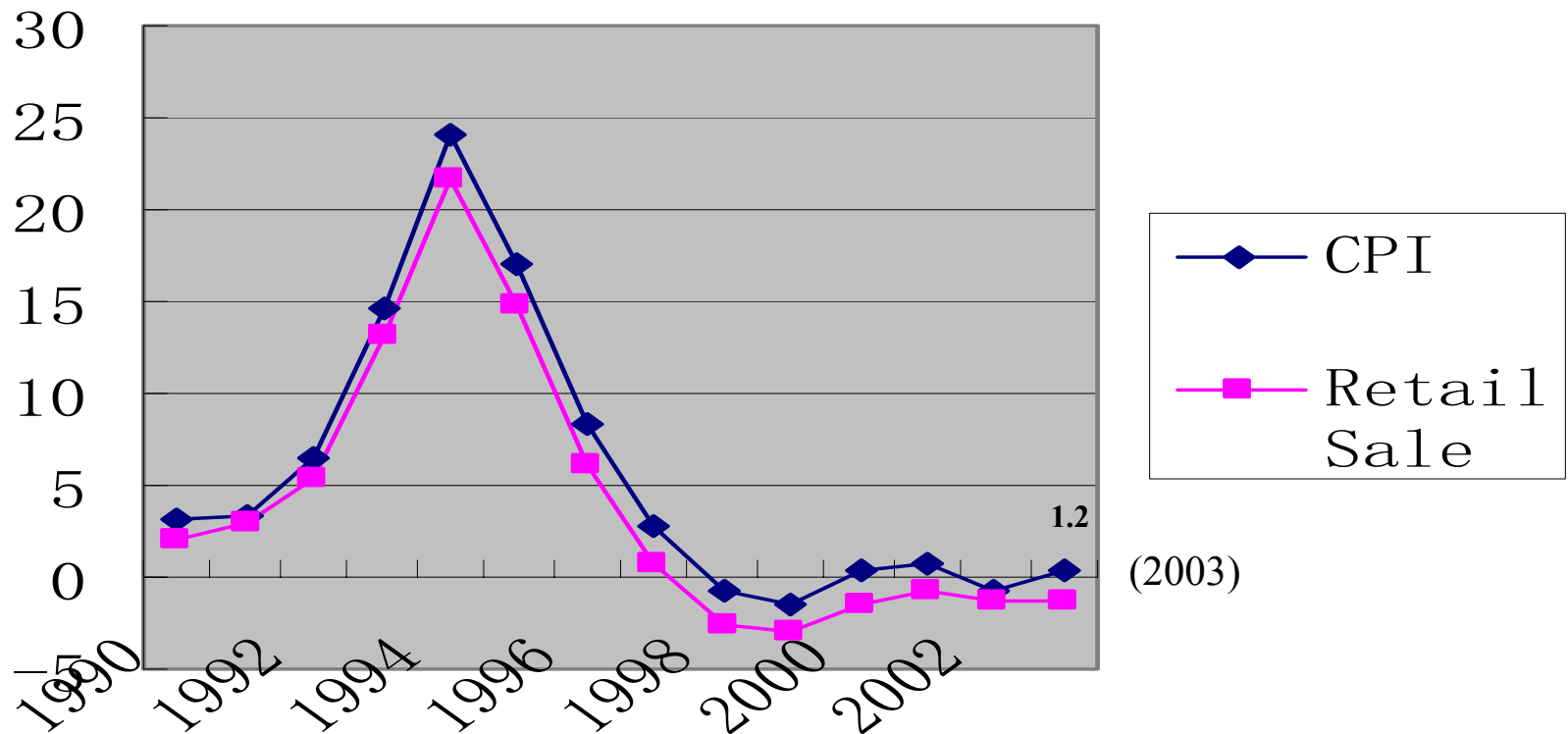


# the capital-output ratio

According to my student's calculation:

- In 2000, for 162,885 large-scale enterprises, covering all major sectors in China, the average capital-output ratio is 2.04.
- For the most inefficient industry-- coal mining, the capital-output ratio is 3.39.
- Given these figures, and assuming that China's financial system is very inefficient in allocating funds, namely,  $a=40\%$  (meaning more than a half of financial resources will be wasted), China still can get a growth rate of 8 percent.

# Inflation and deflation in China



Since middle of 1997, China's all major price indexes have been in declining. By the end of 2003, changes in all major price indexes have become positive. It should be no problem with 8% growth rate vis-à-vis 3% inflation

# Driving forces behind China's growth

- **Institutional reforms**

- *The delegation of decision-making power to producers*
- *The organization of competitive markets*
- *The Creation of incentive systems* **Structural adjustment**
- *Channeling resources to more productive areas and sectors (coastal areas, urban areas) via market force as well as policies*
- *Closing down unproductive industries and factories*

- **Opening up**

- *The utilization of comparative advantage by developing foreign trade*
- *The introduction of advanced technology, managerial skills embodied in foreign goods*

- **Financial deepening**

- *From a mono-bank to a modern banking system Development of money markets and capital markets*

- **High savings rate**

- **Abundant supply of skilled labor force**

## II Major Economic Problems faced by China

1. Unemployment
2. Rural Issues
3. Inequality
4. NPLs
5. Unpaid Pensions
6. High M2/GDP ratio
7. Deterioration of environment  
(desertification) and exhaustion of  
national resources (water and oil)



# Unemployment

- In China, annually, the number of newly added labor force in urban areas is more than **ten to twenty million** (in 2003 it was 14 million)
- There are many times more, perhaps two hundred million, **rural migrants** who are moving around the country to search jobs.
- In more than 1,000 Chinese universities, there are over **900,000 graduates** leaving schools every year. Nowadays, young Chinese graduates find that it is increasingly more difficult to find jobs.
- In the next several decades, **China needs continuously to create 10 to 20 million jobs to absorb the several hundred million farmers** who will become urban residents (now China's 70 percent of population are farmers, the percentage needs to be reduced to less than 10 percent to make China an industrialized country)

# Rural Issues

To solve the so-called “ three nongs” problem (Villages--NongCun, Agriculture—NongYe, and Rural Households--NongMin, thereafter VAR problem) is the top priority of the government.

***how farmers’ rights on land can be protected***

Use-ownership of land

***How Rural incomes can grow fast***

the gap between urban income and rural income is 3 to 1  
fees and charges imposed on  
farmers are heavy

***How basic public facilities can be provided***

lack of basic public facilities is serious (free education, medical cares, social securities)

# **Serious NPL Loan Issue**

- Before 1999: **20%** of Loans outstanding; JP Morgan:36%; Moody 70%;others 40%.
  - 270 billion RMB capital injection
  - 1 trillion RMB debt-equity swap (AMCs) and sold at discount
  - Write off by banks
  - 45 billion USD FX injection
  - 2.4 trillion NPLs remain on the book
- 2003: China's own estimate: **15%**

# **The Widening Gap of Income Distribution in China.**

- **Gini Coefficients for the top ten most unequal countries and China's Gini coefficient**

- 

<b>Countries</b>	<b>Gini Coefficients</b>
• <b>Sierra Leone</b>	0.629
• <b>Brazil</b>	0.601
• <b>Guatemala</b>	0.596
• <b>South Africa</b>	0.593
• <b>Paraguay</b>	0.591
• <b>Columbia</b>	0.572
• <b>Panama</b>	0.571
• <b>Zimbabwe</b>	0.568
• <b>Chile</b>	0.565
• <b>Guinea-Bissau</b>	0.562
• <b>Warning line</b>	0.4
• <b>China (1994)</b>	0.434
• <b>China (2000)</b>	0.458



# The Problematic Pension System

China's current pension system is a combination of "pay as you go" and pension funds in the form of social pools and individual accounts. However, the transition cost is high and the system is flawed with serious problems

- **Excessively High Contribution Rate**

Under the current system, the average contribution (made by both employers and employees) rate of enterprises has already reached 20% of total wages in Beijing

- **Excessively High Replacement Rate**

The target replacement rate of China's basic pension program is, in theory, set around 60%. But in practice, in some provinces and cities, the actual replacement rate is much higher

- **Excessively High Dependency Ratio**

Owing to the fast aging, the dependency ratio in China is excessively high. In 1980, the dependency ratio was only 1: 13, but in 2002 it jumped to 1: 3

- **Excessively Low Coverage Rate**

Chinas pension system covers only the salaried population in cities and towns.

As a result, while the central government has to subsidize local pension programs, money in the individual accounts is siphoned to fill the shortage in social pools from which money is paid to current retirees

## Central Government Subsidies to the Basic Pension programs: From 1998 to 2002 (Unit: billion)

Year	Subsidies for the Basic Pension programs	Payments to Laid-off Workers
1998	2.4	7.57
1999	17.5.	9
2000	33.8.	13.26
2001	34.9.	13.53
2002	40.8.	13.9
Total	129.4.	57.26

Following the passage of time, the shortage will increase steadily, especially, when the government has to make up the money impropriated from the individual accounts.

High M2/GDP ratio

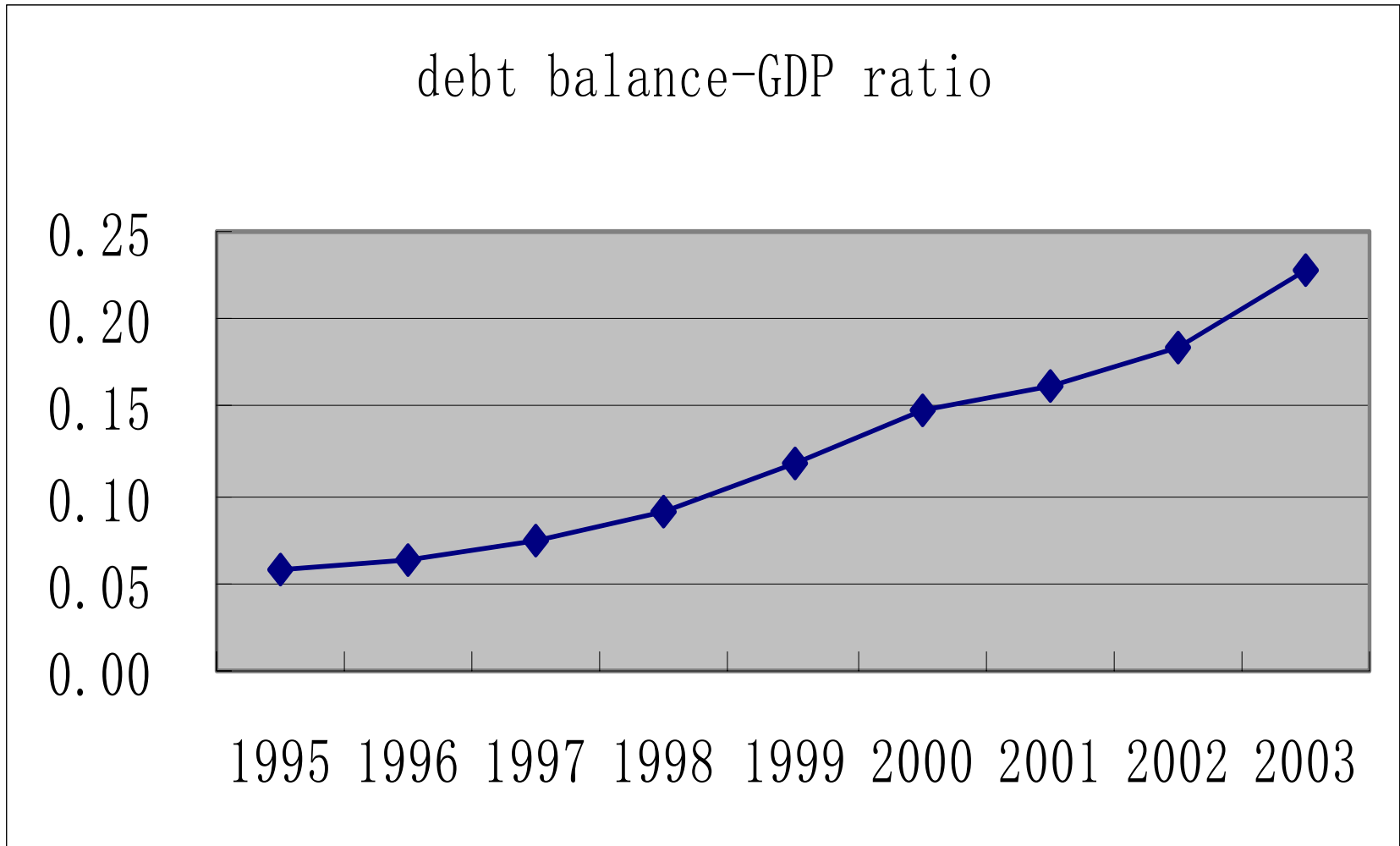


# Fiscal Sustainability

- China's long-term problems boil down to the question of fiscal sustainability.
- If and only if China has sufficient fiscal resources over time, non of the above mentioned problems will trigger a crisis
- Then what is China's current fiscal situation and what will it be in the long-run?

项目	2000	2001	2002	2003
General government incomes	17.6	22.4	15.5	13.7
% GDP	15.0	17.1	18.5	19.4
General government expenditures	20.9	18.7	17.0	11.1
public works	3.3	17.5	23.6	-2.1
Social security	62.5	33.8	35.0	17.4
Interest payments	1.9	7.3	-12.6	40.6
Deficit/GDP	2.8	2.6	3.1	2.7
Debt balance	25.0	17.7	20.0	34.5
Debt balance/GDP	14.8	16.3	18.3	22.7

The following is current situation



Provided that the assumptions hold we will have the following dynamic path of China's fiscal position.

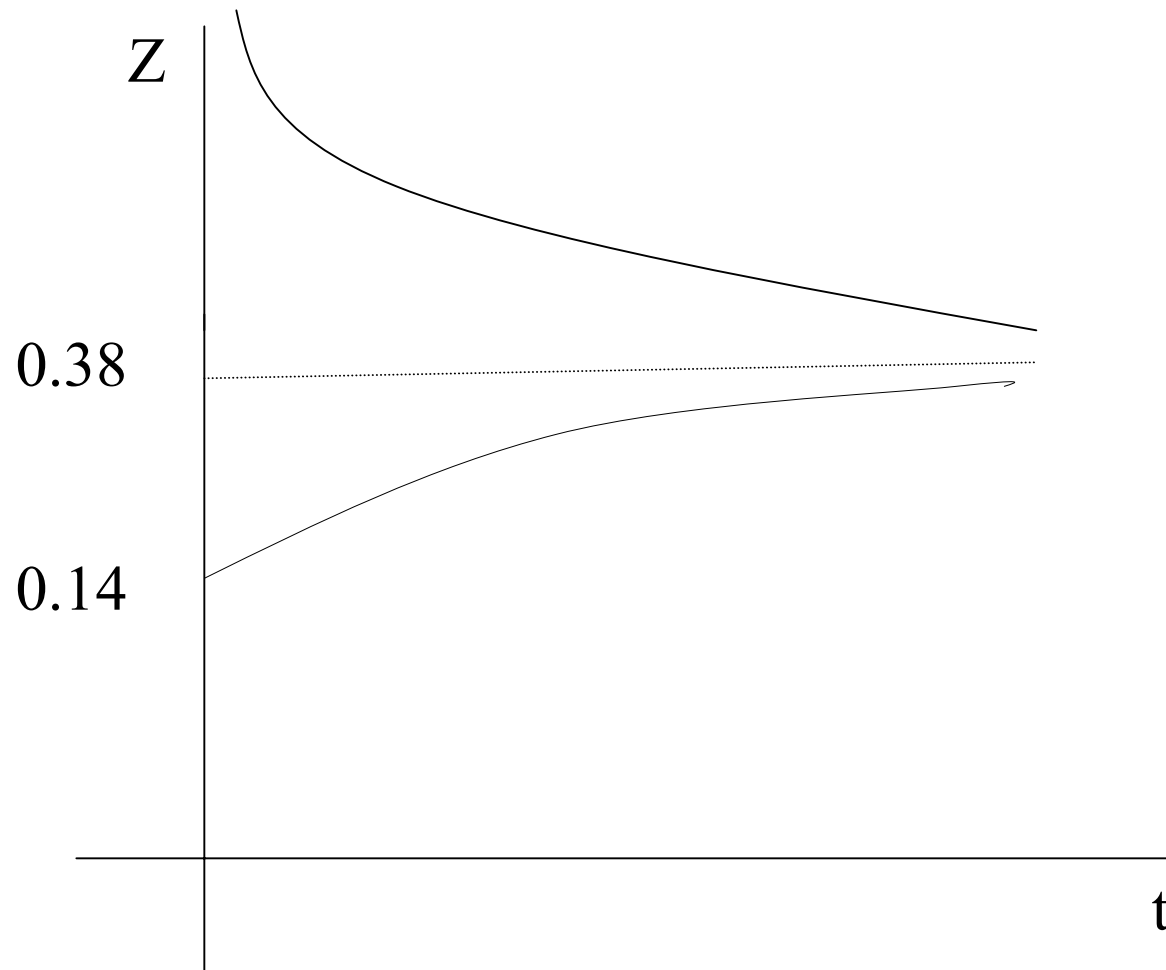


# The long-run perspective of China's fiscal position

- Taking into consideration of contingent liabilities, China's fiscal position is much worse.
- However, as long as China can maintain a high growth rate above 8% and keep budget deficit over GDP ratio below 3%, China's debt balance over GDP ratio will be maintained at a comfortable stable level.

# The Dynamics of the Debt/GDP ratio ( $Z$ )

Assuming growth rate=8%, budget deficit/GDP=3%



# Concluding remarks

- China's economic situation is very good
- The problems China is facing are serious
- As long as reform can be deepened, China will grow out its problems and emerge as a newly industrialized country